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RESIDENTIAL UTILITY CONSUMER OFFICE

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Janet Napolitano
Governor

Stephen Ahearn
Director

October 21, 2008

Mike Gleason, Chairman
William Mundell, Commissioner
Jeff-Hatch Miller, Commissioner
Kristin Mayes, Commissioner
Gary Pierce, Commissioner
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, Arizona 85007

Arizona Corporation Commission

DOCKETED

OCT 21 2008

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Re: ACC Docket W-01303A-05-0405 et al.

W-01303A-05-0910

Dear Commissioners:

I am writing to advise the Commission of a concern I have regarding the recent decision in Arizona-American's application for authorization to implement Step-Two of its Arsenic Cost Recovery Mechanism ("ACRM") in its Paradise Valley District. The Commission, by a 5-0 vote, approved Step-Two of the ACRM, including \$2.5 million of capital costs incurred outside of the Company's Step-One application. While I considered an application for rehearing under A.R.S. §40-253, I believe in this instance that the better approach is to file this letter and remind the Commission of the concern.

The facts are straightforward and the issue simple: RUCO objected to the inclusion of capital costs in the Company's Step-Two application. RUCO Chief Counsel Dan Pozefsky provided the background and pointed to the corresponding record in the comments filed on RUCO's behalf on October 6, 2008 and his remarks before the Commission at the Open Meeting on October 16, 2008.

So that there is no misunderstanding, RUCO appreciates the situation that the federal arsenic standard has left this and other of Arizona's water companies. RUCO has demonstrated its resolve to help Arizona's water companies come into compliance by actively participating and being a part of the ultimate solution that the Commission has endorsed for the last five years.

That solution, of course, was the design of the ACRM Step-Two methodology that arose from the Arizona-Water Northern Division case – Decision No. 66400 docketed on October 14, 2003. There is no question that the two-step ACRM was designed to recover the capital costs in Step-One and certain narrow operation and maintenance expenses in Step-Two. A simple review of Decision No. 66400, which I have attached, makes this clear. Moreover, at least one member of my staff was a part of those discussions and specifically witnessed members of Staff and Arizona Water answering our specific question on the topic, assuring that capital costs would not be included in Step-Two. That was the principal reason why RUCO did not oppose the Step-Two order at that time, or since. Mr. Broderick, an employee of Arizona-American, corroborated the Arizona Water Step-Two Decision in Arizona-American Water's last multi-district rate application¹. See Decision No. 68310 at 8 attached hereto. In sum, the inclusion of capital costs was never intended to be a part of a Step-Two application.

Nonetheless, the Commission's recent decision has now provided precedent and permission for every water utility with an arsenic problem to seek recovery of capital costs in a Step-Two filing. There will no longer be an incentive to finish capital projects in the first phase.

As importantly, I feel the integrity of the Commission's settlement process is being eroded and jeopardized by this decision. My policy is to always consider, review and analyze settlement proposals. RUCO trusts that when it takes a position that allows for a settlement, the Commission—should it ultimately approve the settlement—will follow through with the intent of the parties unless there are extenuating circumstances which require changing the terms of the settlement. Here, where no party suggested an extraordinary² circumstance, it should be incumbent on the Commission to honor its previous order and its clearly-expressed intent. The Commission's decision in this matter jeopardizes the integrity of settlement processes generally going forward.

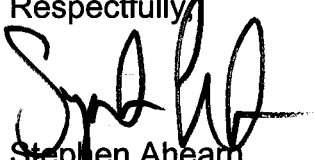
¹ While the Paradise Valley District was a part of that case, the ACRM request for Paradise Valley was considered separately. Nonetheless, Mr. Broderick's testimony on the ACRM is indicative of how the Company envisioned the step-two filing.

² To the extent the circumstances could even be considered unusual in this case, it would be to further the argument that capital costs should be excluded from Step-Two consideration. Unlike the normal situation, the Company has a pending rate case in which the Company's capital costs and operating and maintenance costs will be considered. RUCO has advised the Commission that it would not object to the inclusion of the post test year capital costs at issue in the pending case.

Letter to Commissioners
October 21, 2008
Page 3

RUCO will not request that the Commission revisit its decision in this instant matter. However, I hope that the Commission will consider RUCO's concern in the next proceeding wherein a company seeks approval of capital costs in a Step-Two filing, and that it express forcefully the previously well-understood intent of which costs are to be included in which filings at that time.

Respectfully,

A handwritten signature in black ink, appearing to read "Stephen Ahearn", written over the printed name.

Stephen Ahearn
Director, RUCO

SA:hs

RUCO

BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

COMMISSIONERS

DOCKETED

NOV 14 2005

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

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STATE OF ARIZONA
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IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR
AUTHORITY TO IMPLEMENT ARSENIC COST
RECOVERY MECHANISMS FOR ITS AGUA
FRIA WATER, SUN CITY WATER WEST,
HAVASU WATER AND TUBAC WATER
DISTRICTS.

DOCKET NO. W-01303A-05-0280

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON FOR
UTILITY SERVICE BY ITS SUN CITY WEST
WATER AND WASTEWATER DISTRICTS.

DOCKET NO. WS-01303A-02-0867

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON FOR
UTILITY SERVICE BY ITS MOHAVE WATER
DISTRICT AND ITS HAVASU WATER
DISTRICT.

DOCKET NO. WS-01303A-02-0869

IN THE MATTER OF THE APPLICATION OF
ARIZONA-AMERICAN WATER COMPANY,
INC., AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE CURRENT FAIR
VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
RATES AND CHARGES BASED THEREON FOR
UTILITY SERVICE, ITS AGUA FRIA WATER BY
ITS ANTHEM WATER DISTRICT, AND ITS
ANTHEM/AGUA FRIA WASTEWATER
DISTRICT.

DOCKET NO. WS-01303A-02-0870

DECISION NO. 68310

OPINION AND ORDER
PHASE II (ARSENIC TREATMENT
COST RECOVERY MECHANISM)

1 poor earnings (Ex. A-5, at 6).

2 13. Mr. Broderick described the mechanics and timing of the ACRM filings and what
3 costs would be recoverable in each step of the ACRM as follows:

- 4 a) In the step one filing, which would be filed at any time after
5 January 23, 2006 and would include the 10 schedules of
6 information specified in Decision No. 66400, the Company could
7 seek rate recovery of capital costs for arsenic treatment facilities
8 that are *up and running*, and could begin deferral of recoverable
9 O&M costs related to those facilities;
- 10 b) The Company anticipates that the parties (Staff and RUCO) would
11 then have an opportunity to review the filed information for each
12 district for which the schedules are submitted, and the Commission
13 would issue an Order approximately one month later approving a
14 specific ACRM surcharge for that particular district;
- 15 c) In the second step filing, which would be filed after January 23,
16 2007 and would again include the 10 schedules of information
17 specified in Decision No. 66400, the Company could seek
18 recognition of the prior 12 months of deferred O&M costs, as well
19 as ongoing O&M costs;
- 20 d) The parties would again have an opportunity to review the second
21 step filings, and the Company anticipates that a Commission Order
22 would be issued approximately one month later approving the Step
23 2 surcharge for arsenic treatment facilities;
- 24 e) Approximately one year later (*i.e.*, March 2008), the recovery of
25 the *deferred* O&M costs would automatically cease and the
separate line item for that charge would disappear. However, the
Company would continue to recover the recurring recoverable
O&M expenses authorized in Step 2; and
- 26 f) The ACRM surcharge would remain on customer bills until the
effective date of new permanent rates for the relevant district, at
which time the ACRM would cease. Under Staff's
recommendation, Arizona-American would be required to file the
permanent rate case by no later than April 30, 2008, based on a
2007 test year, to eliminate the ACRM (Tr. 48-49; Ex. A-5, at 11-
13).

26 14. Mr. Broderick testified that the capital costs alone for the three affected districts in this
27 proceeding are estimated to total \$22.0 million based on the following cost projections: Havasu \$1.7
28 million; Sun City West \$10.3 million; and Agua Fria \$10.0 million. Mr. Broderick also provided an

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 COMMISSIONERS

Arizona Corporation Commission

DOCKETED

OCT 14 2003

3 MARC SPITZER, Chairman
4 JIM IRVIN
5 WILLIAM A. MUNDELL
6 JEFF HATCH-MILLER
7 MIKE GLEASON

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NR

8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA WATER COMPANY, AN ARIZONA
10 CORPORATION, FOR ADJUSTMENTS TO ITS
11 RATES AND CHARGES FOR UTILITY SERVICE
12 FURNISHED BY ITS NORTHERN GROUP AND
13 FOR CERTAIN RELATED APPROVALS.

DOCKET NO. W-01445A-00-0962

DECISION NO. 66400

OPINION AND ORDER
PHASE II (ARSENIC TREATMENT
COST RECOVERY MECHANISM)

14 DATES OF HEARING:

October 3 and 18, 2002; June 26, 2003

15 PLACE OF HEARING:

Phoenix, Arizona

16 ADMINISTRATIVE LAW JUDGE:

Dwight D. Nodes

17 APPEARANCES:

Mr. Norman James, FENNEMORE CRAIG, on behalf
of Arizona Water Company;

Mr. Daniel W. Pozefksy, Attorney, on behalf of the
Residential Utility Consumer Office;

Ms. Kay Bigelow, City Attorney, on behalf of the City
of Casa Grande;

Mr. Walter W. Meek, on behalf of the Arizona Utility
Investors Association, Inc.; and

Mr. David Ronald, Staff Attorney, Legal Division, on
behalf of the Utilities Division of the Arizona
Corporation Commission.

22 BY THE COMMISSION:

23 **I. INTRODUCTION**

24 Arizona Water Company's ("Arizona Water" or "Company") Northern Group serves
25 approximately 16,000 customers under five different sets of rate schedules (Sedona, Pinewood,
26 Rimrock, Lakeside, and Overgaard). In November 2000, Arizona Water filed an application with the
27 Arizona Corporation Commission ("Commission") for rate increases for the five Northern Group
28 systems. In its application, Arizona Water also sought approval to reorganize these systems into two

1 divisions with consolidated rate schedules, and to establish an accounting mechanism to track capital
2 costs and operating expenses related to arsenic treatment and removal to be recovered by the
3 Company upon filing of a notice letter. Arizona Water's request for recovery of arsenic treatment
4 costs arises from rules established by the United States Environmental Protection Agency ("EPA")
5 that require maximum contaminant levels ("MCL") for arsenic in potable water to be reduced from
6 50 parts per billion ("ppb") to 10 ppb, effective January 2006.

7 In August 2001, Arizona Water requested that a separate phase of its rate case be established
8 for purposes of developing an appropriate methodology for recovery of costs associated with the new
9 arsenic MCL requirements. The Company's bifurcation request was not opposed by Staff or the
10 Residential Utility Consumer Office ("RUCO"). By Procedural Order issued October 12, 2001,
11 Arizona Water's request was granted, and the parties were directed to engage in discussions, and file
12 periodic reports, regarding methodologies that may be utilized to deal with cost recovery of arsenic
13 treatment costs.

14 In Decision No. 64282 (December 28, 2001), the Commission approved a rate increase for
15 Arizona Water's Northern Group of approximately 16 percent. In that Decision, the Commission
16 affirmed the need for Phase II to address arsenic treatment cost recovery and ordered that this docket
17 would remain open for an additional 180¹ days to allow the parties to develop a proposed procedure
18 for the recovery of such costs. In addition, the Commission stated that it would "consider Arizona
19 Water's rate consolidation proposal in the context of the parties' ongoing discussions regarding
20 recovery of arsenic MCL capital costs" (Decision No. 64282, at 21).

21 Arizona Water, Staff, and RUCO continued discussions on the Phase II issues (arsenic
22 treatment cost recovery and rate consolidation) and filed a Final Joint Report on May 30, 2002. At
23 the parties' request, a Procedural Conference was conducted on July 16, 2002. On July 23, 2002, a
24 Procedural Order was issued establishing deadlines for filing testimony, publication of notice, and
25 setting a hearing for October 3, 2002 to address issues that remain unresolved from the parties'
26 negotiations. Arizona Water published notice in the *Sedona Red Rock News* and the *White Mountain*

27 _____
28 ¹ At the request of Arizona Water, the timeline for consideration of these "Phase II" issues was extended, without
objection, until May 1, 2003.

1 *Independent* in accordance with that directive.

2 The Phase II hearing was conducted on October 3 and 18, 2002. A single set of simultaneous
3 briefs were filed on December 6, 2002 by the Company, Staff, and RUCO.

4 On April 8, 2003, a Recommended Opinion and Order was issued by the Administrative Law
5 Judge. The Recommended Order was discussed at the Commission's April 22, 2003 Open Meeting
6 during which the Commission directed the Hearing Division to conduct additional proceedings
7 regarding the inclusion of potential leasing options for Arizona Water's arsenic treatment facilities.
8 The Commission also directed the Company to investigate all possible loans and grants that may be
9 available for financing installation of arsenic treatment facilities. At the Open Meeting, Arizona
10 Water, Staff and RUCO all expressed an interest in discussing the issue of leasing options prior to a
11 hearing being held.

12 On April 25, 2003, a Procedural Order was issued stating that the parties would be afforded
13 the opportunity to engage in settlement discussions on the leasing issues raised by Arizona Water.
14 Settlement discussions were to be completed by May 30, 2003², and a hearing date of June 26, 2003
15 was established in the event that consensus was not achieved regarding the issues discussed at the
16 April 22, 2003 Open Meeting.

17 On April 28, 2003, the Arizona Utility Investors Association, Inc. ("AUIA") filed an
18 Application for Late-Filed Intervention. AUIA's intervention was subsequently granted.

19 On June 18, 2003, Arizona Water, Staff, RUCO, and AUIA filed testimony regarding the
20 additional issues discussed during the April 22, 2003 Open Meeting. The hearing on these issues was
21 held, as scheduled, on June 26, 2003. Additional post-hearing briefs were filed by the parties on
22 August 15, 2003.

23 **II. DISCUSSION**

24 The parties are in general agreement that some form of streamlined cost recovery is
25 appropriate to enable Arizona Water to recover costs associated with arsenic treatment compliance.
26 There is recognition by Staff that the EPA's new MCL standards will require Arizona Water, as well
27

28 ² By Procedural Order issued June 6, 2003, the settlement deadline was extended until June 9, 2003.

1 as other affected water companies, to incur significant costs to come into compliance with the revised
2 standards. For example, Staff witness Gordon Fox testified that a large number of Arizona water
3 utilities will be adversely affected by the MCL requirements to the extent that arsenic removal costs
4 could harm their financial integrity. Mr. Fox added that "a stream-lined procedure could reduce the
5 overwhelming administrative preparation and processing anticipated by the normal rate case and
6 financing cases anticipated..." (Ex. S-1, at 3-4). Staff witness Steve Olea agreed that, without some
7 form of streamlined cost recovery procedure, the magnitude of the costs required for arsenic MCL
8 compliance could affect the financial integrity of a number of companies, including Arizona Water
9 (Tr. 149, 172).

10 Arizona Water's Northern Group has three water "systems" that rely on groundwater
11 containing levels of arsenic in excess of the new MCL standards: Sedona, Valley Vista, and Rimrock
12 (Ex. A-2). Regarding the magnitude of arsenic-related costs, and their potential impact on Arizona
13 Water, the Company estimates that the capital costs (i.e., the cost to construct new facilities for
14 arsenic treatment) for the Sedona system (including Valley Vista - which is already encompassed
15 within the Sedona system for ratemaking purposes) will be approximately \$2.4 million, compared to
16 a total rate base of \$6.3 million. For the Rimrock system, the arsenic treatment capital costs are
17 projected to be \$1.3 million, compared to a total rate base of only \$1 million. Arizona Water
18 estimates its total capital costs will approach \$30 million, on a company-wide basis³.

19 In addition to the capital costs, Arizona Water projects that operation and maintenance
20 ("O&M") costs associated with the new arsenic treatment plant facilities will be approximately
21 \$544,000 and \$531,000 annually for the Sedona and Rimrock systems, respectively. Based on the
22 operating income authorized in Phase I of this case, the annual arsenic treatment O&M costs would
23 represent 90 percent of the Sedona system required operating income, and more than 5 times the
24 required operating income for the Rimrock system (Decision No. 64282, Ex. C; Ex. A-2). Staff's
25 engineering witness, Marlin Scott, agreed that, based on an EPA publication of estimated costs, the
26 Company's capital and O&M projections are reasonable (Tr. 255-256).

27
28 ³ Company witness Ralph Kennedy testified that arsenic compliance capital costs for the Company's Eastern and Western Groups are estimated to be approximately \$12 million and \$13.5 million, respectively (Ex. A-1, at 8).

1 These estimated costs point out the magnitude of the problem that faces Arizona Water with
2 respect to compliance with the new arsenic MCL requirements. There is no debate by the parties that
3 some form of abbreviated cost recovery procedure is justified given the extraordinary nature of the
4 expected costs, and in order to ensure that the arsenic treatment compliance costs do not compromise
5 the Company's financial integrity and ongoing viability.

6 Company witness Kennedy stated that the parties agree that a step increase procedure, called
7 an Arsenic Cost Recovery Mechanism ("ACRM"), should be approved by the Commission to allow
8 the Company a return on the arsenic MCL capital costs for completed facilities, once such facilities
9 are placed in service and actually serving customers. Under this proposal, two or three increases
10 would be permitted for facilities placed in service between 2003 and January 2006. These capital
11 costs would be recovered through a separately identified surcharge on customer bills.

12 There remains disagreement, however, regarding specific aspects of the proposed recovery
13 mechanism. Each of these points of disagreement is discussed below.

14 A. Recovery of O&M Expenses

15 As indicated above, the parties are in agreement that the ACRM should permit recovery of
16 capital costs⁴ expended to construct arsenic treatment plant, once that plant is operational and serving
17 customers (Ex. S-3, at 3; RUCO Ex. 1, at 7).

18 The issue of O&M cost recovery is the most significant disputed issue in this proceeding.
19 During the initial Phase II hearing, Arizona Water clarified that it does not intend to seek recovery of
20 estimated O&M expenses but, instead, would seek recovery of actual recorded expenses or specific
21 known and measurable expenses related to an operating lease of arsenic treatment facilities (Tr. 29-
22 30). The Company also argued that leasing arsenic treatment facilities may have a lower cost than
23 constructing and operating company-owned plant.

24 Although Staff initially opposed recovery of any O&M costs through the ACRM, following
25 subsequent discussions with the Company, Staff modified its position and now recommends
26

27 ⁴ According to Arizona Water, the specific capital-related costs that would be recovered are the return on the original
28 (actual) cost of constructing the facilities, additional federal and state income taxes relating to the revenue increase,
property taxes, and the depreciation expense associated with the new plant.

1 inclusion of the following specific direct O&M costs: "media replacement or regeneration costs,
2 media replacement or regeneration service costs, and waste media or regeneration disposal costs"⁵
3 (Ex. S-8, at 3). Pursuant to the agreement between Staff and the Company, the "recoverable O&M
4 expenses" will be based on invoices from the contractor providing the services and will be treated the
5 same whether the arsenic treatment facility is constructed by Arizona Water or leased from a third
6 party (Ex. A-3, at 7-8).

7 Under the agreement between Staff and the Company, the recoverable O&M expenses will
8 result from services provided to Arizona Water by third party contractors (Id.; Tr. 362-364).
9 Company witness Ralph Kennedy explained that none of the services listed above are currently being
10 provided by the Company and thus such expenses are not reflected in the Company's rates. Mr.
11 Kennedy stated that Arizona Water intends to contract for these services because of the technical
12 nature of the services and in order to avoid liability regarding disposal of the hazardous waste created
13 by arsenic removal (Id. at 373). The agreement would preclude recovery through the ACRM of other
14 types of O&M expenses which, according to Staff witness Gordon Fox, will make Staff's audit
15 process much easier to complete and prevent any double recovery of expenses (Tr. 397-400).

16 The agreement between Staff and the Company seeks to place the costs of leased treatment
17 facilities on the same level with plant owned and operated by Arizona Water. In order to accomplish
18 this goal, Staff and the Company agreed that all potential lessors of arsenic treatment facilities must
19 agree to break out lease payments into the following three separate components: 1) the lessor's
20 equipment construction costs; 2) recoverable O&M costs (as defined above); and 3) other O&M costs
21 (Ex. A-3, at 7). The lessor will also be required to identify the interest rate embedded in the lease
22 payment (Id.).

23 The so-called "recoverable O&M expenses" are eligible for recovery through the ACRM as
24 follows: 1) costs that have been incurred and deferred in the 12 months prior to the ACRM filing; and
25 2) costs that will continue to be incurred after the ACRM filing. Under the agreement, the deferred
26

27 ⁵ In this context, "media" refers to the material that is used to filter and trap the arsenic. The material must periodically be
28 disposed of and replaced by fresh "media" (Tr. 350). These specific O&M costs are identified by Staff and the Company
as the "recoverable O&M costs" (Ex. A-3, at 7).

1 costs will be recovered through a twelve-month surcharge, while recurring costs will be recovered
2 through an adjustment in base rates. However, Arizona Water will not be entitled to recover interest
3 or financing charges associated with the deferred balance (Ex. A-3, at 8-9⁶; Ex. S-8, at 3-5).

4 With respect to timing, the deferral of recoverable O&M expenses will begin upon operation
5 of the arsenic treatment facility, and will continue until the Company makes an ACRM filing seeking
6 recovery of the deferred recoverable O&M expenses. Arizona Water contends that this treatment
7 addresses Staff's concern that recoverable O&M expenses should be known and measurable rather
8 than estimates. Arizona Water has also agreed to Staff's insistence that the deferral period should be
9 limited to a twelve-month period beginning the later of either the in-service date of the treatment
10 facility or the twelve-month period prior to the month in which the ACRM request is filed. Although
11 the Company has the discretion to choose when to request recovery of each facility's deferred
12 recoverable O&M expenses, it can file only two ACRM filings per water system before the
13 Company's next general rate case for the Northern Group. Recovery of expenses is within the
14 Company's control either through the filing of an ACRM or a full rate application.

15 AUIA supports the agreement reached by Staff and Arizona Water, although AUIA questions
16 the need for "dissecting" a lease into separate O&M and capital-related components (AUIA Ex. 1, at
17 5). AUIA witness Walter Meek testified that Staff's and RUCO's concern with identifying specific
18 O&M costs for arsenic treatment facilities may threaten leasing as a least-cost option for Arizona
19 Water and other affected water utilities in Arizona (Id. at 6).

20 RUCO opposes inclusion of O&M expenses in the ACRM. RUCO witness Marylee Diaz
21 Cortez testified that inclusion of O&M costs in the ACRM audit process would expand the expedited
22 process into a virtual full rate case (Tr. 89-90). Ms. Diaz Cortez also stated that expansion of the
23 ACRM to include O&M would broaden the scope of the process to the point that there would be no
24 assurance that the rates are fair and reasonable (Tr. 91). RUCO argues that the Company should be
25 required to file a full rate case if it seeks to recover O&M costs related to arsenic treatment.

26 With respect to arsenic treatment lease costs, RUCO believes the ACRM should exclude any
27

28 ⁶ An example of the computation of recoverable O&M expenses and capital-related costs under the Staff/Company
proposed modified ACRM is set forth in Exhibit RJK-1 to Mr. Kennedy's testimony (Ex. A-3).

1 O&M costs whether the Company leases or operates the facilities itself. Ms. Diaz Cortez testified
2 that RUCO's recommendation could be accomplished by requiring lease payments to be broken out
3 into capital costs and O&M costs, and allowing the Company to recover a return on, and depreciation
4 of, the incremental arsenic plant. However, under RUCO's recommendation, all O&M costs
5 associated with the arsenic treatment facilities would require examination in a full rate case prior to
6 being afforded recovery (RUCO Ex. 2, at 6-7)⁷.

7 After considering the arguments regarding the O&M recovery issue, we believe the modified
8 ACRM proposed by Staff and the Company is a reasonable compromise of the positions previously
9 advocated by those parties. In addition to providing a mechanism for recovery of capital costs
10 incurred by Arizona Water, which costs are not opposed even by RUCO, the modified ACRM offers
11 the Company an opportunity to recover limited verifiable O&M costs in a timely manner. The
12 proposed ACRM also treats leasing and owning arsenic treatment facilities on an equal basis, thereby
13 affording Arizona Water the flexibility to negotiate the least-cost means of complying with federal
14 arsenic limit mandates. However, the recovery of O&M expenses is confined to specific and
15 narrowly defined costs in order to enable Staff and other parties to more easily audit expenditures
16 incurred by the Company for the treatment facilities. The Company also retains the opportunity to
17 file a general rate application.

18 **B. Number of Step Increases**

19 The parties also disagree regarding the number of step increases that should be permitted prior
20 to the Company's next full rate case in 2007. Arizona Water proposed that it should be entitled to
21 three step increases, while Staff and RUCO recommend that each affected system be limited to two
22 step increases (Ex. A-1, at 10; Ex. S-1, at 11, RUCO Ex. 1, at 5). Arizona Water argues that the
23 ability to request three step increases will allow the Company greater flexibility and will enable it to
24 better match operating income with debt service costs. Arizona Water also contends that three step
25 increases will be preferable for customers because the increases will be implemented in smaller
26 increments. The Company claims smaller increases will be even more important if the Commission
27

28 ⁷ RUCO also raised the argument that the modified ACRM exceeds the scope of the Commission's legal authority with respect to approval of automatic adjustment mechanisms. RUCO's legal arguments are addressed below.